March 9, 2017

Australian Enhanced Income Fund - ASX Code "AYF"
February 2017 Investment Update and NAV

February 2017 NAV and Fund performance

The Fund's NAV of a unit at the close of business on February 28, 2017 was $**6.051** per unit. This compares with the NAV of a unit at the close of business on 31 January of $6.045. The change in NAV over the month of February represents a return of **0.10%.** The franking benefit for February was estimated to be **0.05%**.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.10%	2.73%	10.78%	4.08%
UBS(A) Bank Bill Index	0.13%	0.45%	1.98%	2.32%

*Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance.

Relative performance

- Including the value of franking credits the ASX listed hybrid sector returned 0.22% for the month. This compares with the All Ordinaries Accumulation Index return of 2.09% and the UBSA Bank Bill Index return of 0.13%.

Fund performance

The Fund performed in-line with the market this month. The Fund's rolling annual net return, which excludes the benefit of franking but is net of all fees, for the 12 month period ending 28 February 2017 increased to 10.78% from 10.12% previously.

Another common theme

In our January update we commented on the risk to asset prices of long duration assets of rising discount rates. This theme is now well entrenched in the market's psyche. We thought we would revisit another theme which is very close to us as an investor in 'near equity' instruments. That theme is the equity risk premium or ERP. The ERP is the excess return an investor receives or expects to receive above the risk free rate for investing in the riskier equity. Central to any investment committee meeting is the expectation that equities will, over any reasonable timeframe, outperform the risk free rate. An asset allocation decision is then made around equities based on the magnitude or level of the expected outperformance of equities over the risk free rate (i.e the expectation that the excess return will be large would translate into a higher portfolio weighting to equities and vice versa).

But history is not kind.

The last 35 years has not been all that kind to investors in equities based on the level of outperformance of the risk free rate. The chart overleaf details the outperformance (where either line is above zero) or underperformance (where either line is below zero) of equities of the risk free rate in both the US and Australia since 1980. In Australia's case, the excess return has been negative or only mildly positive for much of period. Perhaps not surprisingly the last decade has been highlighted by extreme volatility of the excess return. Note that in calculating the excess return we have taken the risk free rate to be the bond rate at the beginning of the period.

The drives of the ERP. The future?

In our research we sought to find out what the consistent long term drivers were of the excess return. Not surprisingly, we found that nominal GDP growth, the direction in

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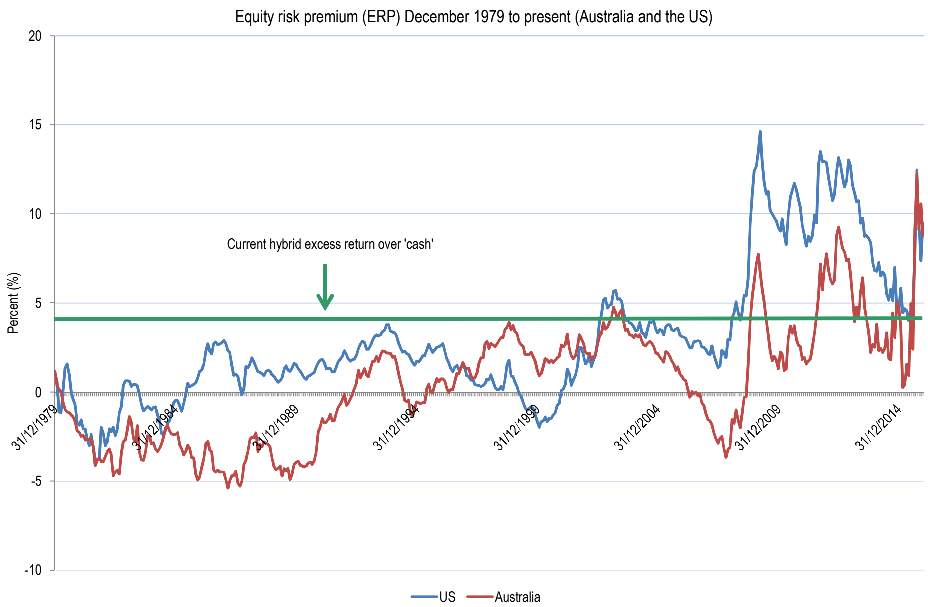
which bond and equity yields (the inverse of the price earnings ratio) moved were all contributing factors. We found that robust economic growth combined with falling bond and equity yields generally contributed to a positive excess return and vice versa. What interests us as investors in hybrids is that an investment in hybrids pays an almost certain excess return over the risk free rate (in this case 'cash') for the life of the investment. That excess return is currently just under 4% (i.e 4% higher than cash). This compares favourably (green line highlighted in the chart) with the equity excess return over almost any time frame since 1980. Perhaps of more interest is that equities face headwinds of rising bond and equity yields as well as sluggish output growth which are, if history is any guide, not conducive to long term out performance of the risk free rate.



Fund ready reckoner. Fund metrics and portfolio characteristics at a glance

	January 2017	February 2017
Net Asset Value (NAV)	**$6.045**	**$6.051**
Change in NAV month on previous month (mopm)*	**0.49%**	**0.10%**
Total investment return includes the value of franking (mopm)	**0.49%**	**0.15%**
Dividend (declared February 2016 and payable 16 February 2017)	**n/a**	**n/a**
Percent franked (*quarterly estimate @ 30% tax rate*)	**n/a**	**n/a**
Cash yield per annum (basis NAV)	**5.78%**	**5.77%**
Grossed up yield basis NAV per annum (*estimated*)	**6.62%**	**6.61%**
Investment grade issuer (including cash)	**90%**	**90%**
Fund average term	**4.2 years**	**4.2 years**
Bank Tier 1 exposure	**52%**	**52%**
Property exposure	**4%**	**4%**

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For additional information please contact **Norman Derham** at Elstree Investment Management Limited on (03) 8689 1348 or by email info@eiml.com.au While the information in this report has been prepared with reasonable care Elstree Investment Management Limited accepts no responsibility for any errors, omissions or misstatements however caused. This is general securities information only and is not intended to be a securities recommendation. This information does not account for your individual objectives, needs or financial situation.

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